Solution 20.1

- In order to issue either the debentures or the redeemable preference shares, the company must be authorized to do so in terms of its articles of association. The articles may be amended to include such authorization provided that the procedures required by the Companies Ordinance,1984 are complied with.

- Both the preference shares and the debentures may be issued as redeemable at the company's option, which would comply with the directors' wish not to be committed to repayment on a specific date.

- Debentures cannot have any voting rights, where as preference shares may have voting rights, if specified in its articles and memorandum of association.

- It may be possible to offer a lower rate of return on the debentures than on the preference shares due to the debentures' preference in the event of liquidation, especially if the debentures are secured.

- An important consideration is the deductibility of interest paid on the debentures and the non-deductibility of dividends paid. The fact that the company is profitable indicates that it is probably in a tax paying position. The after tax cost of issuing debentures will be lower than that of issuing preference shares.

- The difficulties experienced with cash flows may be a problem if the debentures are issued as the interest must be paid on the agreed dates, whereas the dividends on preference shares need not be paid unless profits are available. However, provided the directors are correct about the impact of the new system on stock holdings, tight control is maintained over credit policies and the company continues to operate profitably, it should be possible to meet interest payments without much difficulty.

- Unless new shares are issued for the redemption of preference shares, there will have to be a transfer from retained earnings to a non-distributable reserve (capital redemption reserve fund) equaling the nominal value of the preference shares in terms of Sec 85. This decreases the amount available for distribution to ordinary shareholders. No such restriction applies to redeeming debentures.

- Issuing C500 000 debentures will result in Stylish Limited's gearing increasing to 38%. This is still a comfortable gearing ratio and should not restrict potential future borrowings, provided there is no restriction in the articles of the company.

- Any expenses/commission/premium on redemption relating to the issue of preference shares may be written off existing share premium in terms of Sec 83, therefore not impacting distributable reserves. This is also permitted for similar expenditure relating to debentures, Sec 83 (2) (b).

Solution 20.2

WILLIAMSON LIMITED
EXTRACT FROM THE STATEMENT OF FINANCIAL POSITION
AS AT 28 FEBRUARY 20X4

	Note	C
EQUITY & LIABILITIES		
Capital & reserves		
Share capital		
Distributable reserves - Retained earnings		118 009
Non-current liabilities		
C1 debentures	5	19 413
Current liabilities		
Interest accrued		200

NOTES TO THE FINANCIAL STATEMENTS

5. Non current liabilities

Unsecured	**C**
20 000 C1 debentures	*19 413

These debentures bear interest at 12% p.a. and will be redeemed at a premium of 2% on 31 January 20X9. The effective interest rate is 13.16% p.a.

*Carrying amount at 01/01/X4	19 400
a) Effective interest @ 13.16% (19 400 * 13.16% * 1 / 12)	213
b) Interest @ 12% (accrued) (20 000 * 12% *1 / 12)	(200)
	19 413

Solution 20.2 continued …

Workings

Retained earnings

		C
Balance		120 000
Debenture discount written off	(92 x 1/12)	(8)
Debenture premium accrued	(62 x 1/12)	(5)
Debenture interest accrued	(2 400 x 1/12)	(200)
Premium on preference shares		(278)
Preference dividend		(1 500)
		118 009

Debenture amortisation schedule:

Date	Interest	Effective Interest	Premium (x 0.4)	Discount (x 0.6)	Balance Premium	Balance Discount	PV
1/2/X4						600	19 400
31/1/X5	2 400	2 554	62	92	62	508	19 554
31/1/X6	2 400	2 574	70	104	131	403	19 728
31/1/X7	2 400	2 597	79	118	210	285	19 925
31/1/X8	2 400	2 623	89	134	299	151	20 148
31/1/X9	2 400	2 652	101	151	400	0	20 400

Preference shares

Cash flow	
1/3/X1	15 000
28/2/X2	(1 500)
28/2/X3	(1 500)
28/2/X4	*(17 250)

The effective interest rate is 11.4890387% (PV = 15 000 FV = -15 750 PMT = -1 500 n = 3 COMP i)

	Interest	Effective Interest	Premium	Premium balance	PV
1/3/X1					15 000
28/2/X2	1 500	1 723	223	223	15 223
28/2/X3	1 500	1 749	249	472	15 472
28/2/X4	1 500	1 778	278	750	15 750

* Redemption	15 750
Preference dividend	1 500
	17 250

Solution 20.3

NOURISH LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 28 FEBRUARY 20X7

		C
ASSETS		
Bank	(25 000 + 19 200 – 34 200)	10 000
EQUITY & LIABILITIES		
Capital and reserves		
Ordinary share capital	(100 000 + 16 000)	116 000
Share premium	(25 000 + 3 200 - 600)	27 600
Retained earnings	(78 000 - 3 600 - 1 350 - 34 - 50 – 102 + 600)	73 464
		217 064
Non-current liabilities		
Debentures	(15 000 - 116 + 50)	14 934
Current liabilities		
Interest accrued	(15 000 x 12% x 9/12)	1 350

Workings

Retained earnings

	C
Balance (27/2/X7)	78 000
Transfer to CRRF	(10 800)
Preference dividend	(3 600)
Premium accrued	(102)
Interest on debentures accrued (1 800 x 9/ 12)	(1 350)
Debenture discount written off	(34)
Debenture premium accrued	(50)
Transfer from share premium	600
Balance (28/2/X7)	73 464

Debentures

Date	Interest	Effective Interest	Installment	Premium	Discount	Balance Premium	Balance Discount	PV
01/06/X6							150	14 850
31/05/X7	1 800	1 912		67	45	67	105	14 962
31/05/X8	1 800	1 926	5075	76	50	^68	55	10 013
31/05/X9	1 200	1 289	5075	54	36	47	19	5 028
31/05/Y0	600	647	5075	28	19	0	0	0

Balances at 28/2/X7:
Premium: 9/12*67 = 50
Discount: 9/12*45 = 34 thus balance = 150 – 34 = 116

^ [67 + 76 – 75 (5 000 X 0.015)]

Solution 20.3 continued

Cash needed:

Redemption of preference shares (30 000 x 1.02)	30 600
Preference dividends	3 600
Cash required	34 200
Cash from bank	(15 000)
Cash required from share issue	19 200

S76

Premium	- Share premium*	600
	- Retained earnings	-
		600

Dr	Share premium	600	
Cr	Retained earnings		600

Number of shares to be issued:

19 200 / 1.20 = 16 000 shares

X C1 = C16 000	Share capital
X C0,20 = C3 200	Share premium

Preference shares

	Effective interest	Premium	Premium balance	PV
28/2/W7				90 000
28/2/W8	10 922	122	122	90 122
28/2/W9	10 937	137	259	90 259
28/2/X0	10 953	153	412	90 412
28/2/X1	10 972	172	584	90 584
28/2/X2	10 993	193	777	90 777
28/2/X3	11 016	216	993	90 993
28/2/X4	11 042	242	1 235	91 235
28/2/X5	11 072	272	1 507	91 507
			(600)	(30 600)
			907	60 907
28/2/X6	7 391	191	1 098	61 098
			(600)	(30 600)
			498	30 498
28/2/X7	3 702	102	600	30 600
			(600)	(30 600)
			0	0

Not required

Cash flow			
0	28/02/W7	90 000	
1	28/02/W8	(10 800)	
2	28/02/W9	(10 800)	
3	28/02/X0	(10 800)	
4	28/02/X1	(10 800)	
5	28/02/X2	(10 800)	
6	28/02/X3	(10 800)	
7	28/02/X4	(10 800)	
8	28/02/X5	(41 400)	(10 800 + 30 000 + 600)
9	28/02/X6	(37 800)	(7 200 + 30 000 + 600)
10	28/02/X7	(34 200)	(3 600 + 30 000 + 600)

The effective interest rate is 12.1355013%

Solution 20.4

SCOTT LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 30 JUNE 20Y0

		C
Profit before interest and taxation		265 750
Interest expense	Debentures (15 524 + 15 646) Loan (13 000 + 5 200)	(49 370)
Profit before tax		216 380
Income tax expense		(70 227)
Profit for the period		146 153
Other comprehensive income		0
Total comprehensive income		146 153

SCOTT LIMITED
STATEMENT OF CHANGES IN EQUITY
FOR THE YEAR ENDED 30 JUNE 20Y0

	Ordinary Share capital	Share Premium	Preference Share capital	Retained earnings	Total
	C	C	C	C	C
Balance at 30June 20X9	450 000	50 000	200 000	335 500	1 035 500
Capitalisation issue	50 000	(50 000)			-
Ordinary shares issued during the year	150 000	18 750			168 750
Preference shares redeemed			(200 000)		(200 000)
Premium on redemption of preference shares		(18 750)		(1 250)	(20 000)
Share issue expenses				(1 688)	(1 688)
Total comprehensive income				146 153	146 15
Dividends paid – ordinary				(12 500)	(12 500)
– preference				(30 000)	(30 000)
Balance at 30 June 20Y0	650 000	-	-	436 215	1 086 215

Solution 20.4 continued …

NOTES TO THE FINANCIAL STATEMENTS

1. Share capital

Authorised
500 000 ordinary shares of C2 each
500 000 preference shares of C0.50 each

Issued

	Ordinary share capital	Preference share capital
Number of shares in issue 1 July 20X9	225 000	400 000
Number of ordinary capitalisation shares issued	25 000	
Number of ordinary shares issued for cash during the year	75 000	
Number of preference shares redeemed during the year		(400 000)
Number of shares in issue 30 June 20Y0	325 000	-

The directors have been granted permission to issue the unissued ordinary shares at their sole discretion, at any time before the next annual general meeting.

2. Non-current liabilities

Secured

200 C1 000 Debentures	198 223

The debentures bear interest at 14% p.a. payable on 1 January and 1 July each year. They are redeemable at par on 31 December 20Y0. The debentures are secured by a mortgage over land and buildings of C300 000. The effective interest rate on the debentures is 15.918% p.a.

Unsecured

Loan – Investments Bank	120 000
current portion	(30 000)
	90 000

The loan bears interest at 13% p.a. payable annually in arrears and is repayable in annual installments of C30 000, with the last installment payable on 1 March 20X4.

3. Dividends
The directors declared an ordinary dividend of C32 500 (325 000 X C0,10) on 31 July 20Y0.

4. Authorisation of financial statements
The financial statements were authorised for issue by the board of directors on 5 August 20Y0.

Solution 20.4 continued …

Workings

Debentures

Date	Interest	Effective interest	Discount	Balance discount	PV
1/7/20X7				10 000	190 000
31/12/20X7	14 000	15 122	1 122	8 878	191 122
30/06/20X8	14 000	15 211	1 211	7 666	192 334
31/12/20X8	14 000	15 308	1 308	6 359	193 641
30/06/20X9	14 000	15 412	1 412	4 947	195 053
31/12/20X9	14 000	15 524	1 524	3 422	196 578
30/06/20Y0	14 000	15 646	1 646	1 777	198 223
31/12/20Y0	14 000	15 777	1 777	0	200 000

Interest on bank loan

30/6/X9 to 28/2/Y0	C150 000 *0.13*8/12 = C13 000
1/3/Y0 to 30/6/Y0	C120 000 *0.13*4/12 = C5 200

Preference shares

Sec 83

Premium on redemption	(400 000 X 0,05)	20 000
- Share premium		18 750
- Retained earnings		***1 250***

Final dividend

200 000 X 15% X 6/12 = 15 000